

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

PRICE ELASTICITIES AND INTERNET DIVERSION

Docket No. RM2014-5

**PETITION TO IMPROVE ECONOMETRIC DEMAND EQUATIONS
FOR MARKET-DOMINANT PRODUCTS AND RELATED ESTIMATES OF
PRICE ELASTICITIES AND INTERNET DIVERSION**

(May 2, 2014)

The National Postal Policy Council¹ (“NPPC”), the Association for Mail Electronic Enhancement (“AMEE”),² the Association of Marketing Service Providers (AMSP),³ GrayHair Software, Inc. (GrayHair),⁴ the Greeting Card Association (“GCA”),⁵ the International Digital Enterprise Alliance, Inc.

¹ NPPC is an association of large business users of letter mail, primarily Presort First-Class Mail, but also other First-Class and Standard Mail products. Member companies are in the telecommunications, banking and financial services, insurance, and mail services industries. Comprised of 36 of the largest customers of the Postal Service with aggregated mailings of nearly 30 billion pieces and pivotal suppliers, NPPC supports a robust postal system as a key to its members’ business success and to the health of the economy generally.

² AMEE’s member companies represent mailers, associations, and supporting vendors who have a primary interest in increasing the value and utility of First Class Mail and are engaged in developing and/or promoting technology in the area of mail electronic enhancement.

³ AMSP is the national trade association for the mailing and fulfillment services industry. The association is made up of nearly 500 companies, most of which are located in the USA and Canada.

⁴ GrayHair is an innovator and industry leader in the development of solutions that improve the return-on-investment of business mail. GrayHair Advisors provides strategic and tactical postal consulting services for large business mailers. GrayHair Software provides critical services including address quality (domestic and global), IMb assignment, mail tracking, mail monitoring, presort analysis, postage reconciliation, and global hybrid mail.

⁵ GCA is a nonprofit organization representing approximately 200 publishers of greeting cards and other personal mailing products, and providing a voice for the consumer mailer in all aspects of postal affairs.

("IDEAlliance"),⁶ the Major Mailers Association ("MMA"),⁷ and the National Association of Presort Mailers ("NAPM")⁸ (collectively "Petitioners") respectfully ask, pursuant to section 3050.11 of the rules of practice (39 C.F.R. §3050.11), the Commission to initiate and conduct a proceeding to review and improve the econometric volume demand model and the associated factors relating to price elasticity estimates and Internet diversion used by the Commission and Postal Service.

Petitioners believe that the econometric volume demand model prepared by the Postal Service and used by this Commission materially understates the true price elasticities of demand for major postal products, including but not limited to First-Class Presort Mail, First-Class Single Piece Mail, and Standard Regular Mail. Furthermore, the current demand model also appears incapable of properly accounting for electronic diversion, a major flaw in today's mailing environment. As a result, it likely generates incorrect measures of price elasticity and does not accurately reflect the factors that drive mail demand.

⁶ IDEAlliance® is a global developer of specifications and best practices for print and digital media for its more than 1400 members – agencies, brands, publishers, print and premedia service providers, and their materials and technology partners. Through its committees and training and certification programs, IDEAlliance provides its members the network to create the industry's most valued standards, more efficient supply chain, and integrated media workflows. www.idealliance.org.

⁷ MAA is comprised of companies that serve the communications, utilities, insurance, banking, financial services, healthcare, government and cable/satellite industries. Although there has been diversion to electronic channels, these industries still rely primarily on the USPS for the delivery of the statements, invoices, remittance payments and other business communications.

⁸ NAPM is a nonprofit organization that represents mailers, both mail owners and mailing service providers who commingle, sort and prepare quality mailings inducted and compliant with work share requirements. Representing over 100 member companies mailing in 36 states, it collectively provides approximately 35% of the total First Class mail volume and over 50% of the Full Service volume. NAPM member mail service provider companies interact with and perform mailing services for tens of thousands of clients and businesses that use postal mailing products.

The objective of this proceeding is to correct these problems and thereby improve the modeling of demand for postal products and their sensitivity to price changes. The Commission, Postal Service, and mailing community would benefit from improved understandings of both electronic diversion and price elasticities.

In Section III, petitioners suggest an approach for the Commission to consider taking in this proceeding. One important step is to improve the econometric model. Another important step would be to develop firm-level models of the demand for transactional and marketing mail, to develop similar models for the consumer mail market, and to aggregate the results from those models to produce industry level price elasticities. Comparing these results to those from the econometric demand estimates will serve as a check on both approaches.

I. THE POSTAL SERVICE'S CURRENT ESTIMATES OF DEMAND AND THEIR RESULTING PRICE ELASTICITIES ARE OF DOUBTFUL ACCURACY

A. Current Filing Requirements And Uses Of Price Elasticities And Related Volume Models

As required by section 3050.26 of the Commission's rules, the Postal Service files in January of each year its current econometric demand estimation regression model. That model produces price elasticity estimates for postal products on class or product-specific bases. Subsequently, in July of each year the Postal Service files additional material that discusses changes contained in the volume model submitted the previous January.

These Postal Service filings are not placed on public notice, nor does the Commission solicit comment on them. Although, as far as Petitioners are aware, the Commission does not rely on these materials during proceedings to review Market-Dominant price adjustments under the price cap, it does use the model when analyzing the benefits of proposed negotiated service agreements (“NSAs”) in the Market-Dominant category.⁹ The Commission may also do so when considering petitions to transfer products from the Market-Dominant to the Competitive category. In addition, the Commission uses volume forecasts derived from these estimates as needed when preparing various reports.

Finally, those demand equations play an important role in “exigent” rate cases conducted under 39 U.S.C. §3622(d)(1)(E), although in both exigency cases filed to date under the Postal Accountability and Enhancement Act (“PAEA”), the demand equations relied upon by the Postal Service have differed in some aspects from those filed in the preceding January.¹⁰ Only in these proceedings is some opportunity provided for adversarial testing and questioning of the model, its assumptions, and outcomes, although in a time-constrained manner.

⁹ See *Annual Compliance Determination Fiscal Year 2013* at 66-68 (March 27, 2014) (analysis of Discover Financial Services NSA).

¹⁰ Although this petition in part requests a review of important aspects of the volume model used by the Commission in rendering its decision in Docket No. R2013-11, that case is currently under review in the Court of Appeals. The merits of that case will be decided on the record in that docket.

B. There Are Compelling Reasons To Doubt The Accuracy Of The Postal Service's Current Economic Demand Equations And Estimates Of Price Elasticities

In general, there are two basic approaches to determining a price elasticity of demand. One is the approach taken by the Postal Service's demand estimates used in Commission proceedings. Using econometric techniques, it attempts to identify and employ economically relevant and meaningful variables that affect mail volume. A price elasticity estimate can be extracted from the estimated demand equations using the well-known definition of price elasticity as the percentage change in volume divided by the percentage change in price. For this approach to generate valid estimates of price elasticity, demand equations must be specified with relevant and meaningful variables. Misspecified economic demand models are likely to derive unreliable, biased, or otherwise flawed estimates of price elasticity.¹¹

The second approach is to study and analyze mailer behavior using surveys, interviews, and both quantitative and qualitative analysis. This method can yield valuable insights into mailer behavior and lead to improved estimates of actual mailer behavior. However, it also requires cooperation from a sufficient number of mailers to make the results worthwhile and contains some potential for error due to sample selection or other factors.

In the late summer and fall of 2013, some of these Petitioners (with some other mailers) sponsored a study by SLS Consulting, Inc., that surveyed and

¹¹ As a result, either too much or too little of the volume changes that properly should be attributed to price variables would, in fact, be so attributed. In Docket No. R2013-11, the explanatory variables in the Postal Service's model were poorly chosen or, in the case of Internet diversion, simply omitted.

interviewed a number of First-Class and Standard mailers to obtain estimates of price elasticities based on how mailers make mailing decisions, and taking electronic diversion into account. That survey was subsequently submitted in Docket No. R2013-11. See Statement of Lawrence G. Buc of SLS Consulting, Inc. ("*Buc Declaration*").¹²

That effort suggested that the price elasticities of First-Class Presort and Single-Piece mail, and of Standard Regular, are far more price sensitive than the Postal Service's econometric demand model indicates, and close to elastic levels. *Buc Declaration* at 6. Notably, based on its interviews and surveys of Standard mailers, SLS calculated that the price elasticity of Standard Regular mail (assuming a 4 percent price increase) was -1.12 , or elastic. Although SLS did not estimate a price elasticity for First-Class Single Piece or Presort mail, the surveys provided ample reason to suspect that the price elasticity of demand for those products – possibly as much as -1.0 -- is materially more elastic than the Postal Service's model indicates. *Buc Declaration* at 16. Interestingly, the Postal Service conducts these kinds of surveys from time to time for some purposes, but has not submitted them in Commission rate proceedings.¹³

Ideally, the estimates of price elasticity of demand derived from these two approaches – if properly structured and executed -- would converge.

Unfortunately, in today's postal world, they do not. Instead, they vary widely. In

¹² See also Declaration of Arthur B. Sackler, attached to Comments of the National Postal Policy Council in Opposition To Exigent Rate Increase, Docket No. R2010-4 (Aug. 17, 2010) ("*Sackler Declaration*") (summarizing mailer reaction to above-inflation price increases).

¹³ The Postal Service did submit a mailer survey in Docket No. N2012-1, but that did not focus on prices.

contrast to the elasticities suggested by the SLS survey, the Postal Service volume model used in the recent Docket No. R2013-11 generated price elasticities of -0.157 for First-Class Single Piece, -0.345 for First-Class workshared mail, and -0.464 for Standard Regular mail. Docket No. R2013-11, USPS-R2010-4R/9, AfterRates-Exig-Oct.xlsx. These estimates are essentially unchanged in the recent January 2014 update, which is unsurprising because few additional postal quarters are in the data and the model specifications are changed only in minor ways.¹⁴

That the elasticity estimates generated by the current econometric model and those derived from surveying major mailers differ significantly is a substantial concern. While such surveys may not be perfect, Petitioners have suspected for a number of years that the price elasticities generated by the model do not reflect the real-world experience of mailers and mailing services providers. In addition to its divergence from the results of surveys of mailers, there are other reasons to question the accuracy of the Postal Service's current estimates of price elasticity.

First, the Postal Service has stated – elsewhere -- that electronic diversion has not only significantly affected the demand for mail, but is a “primary cause” of and “principal contributor” to volume declines.¹⁵ If so, one would expect the

¹⁴ For example, the Postal Service volume model filed on January 22, 2014, only a few months after the Thress model was filed in Docket No. R2013-11, estimated the price elasticity of the of First-Class Single Piece product of -0.157693; First-Class Presort as -0.339; and of Standard Regular of -0.457163. *Econometric Demand Equations for Market Dominant Products as of January 2014* at 5, 22, and 39.

¹⁵ See *United States Postal Service, “Ensuring a Viable Postal Service for America: An Action Plan for the Future,”* at 4 (Mar. 10, 2010) (stating that the “primary cause [of the volume decline] is a fundamental and permanent change in mail use by households and businesses. Hardcopy communication of all types continues to shift to digital alternatives. More people are paying bills and transacting business online.” *United States Postal Service, “Plan To Profitability,”*

econometric model to account for such diversion, but it does not even include a factor for electronic diversion. Why the Postal Service has chosen never to file those conclusions and the studies on which they were based in Commission rate proceedings is unknown. Nevertheless, that these other studies reach conclusions that appear at odds with the Postal Service's econometric model simply casts more doubt on the model.

Second, without accurately accounting for diversion, an econometric model is unlikely to produce an accurate price elasticity. However, the Postal Service has struggled for years to factor electronic diversion directly in its volume models. At various times, it has modeled electronic diversion by including measures of Internet consumption (e.g., broadband subscriber penetration, Internet Services Providers consumption) as factors in its equations. Later, it briefly tried forecasting Internet multipliers explicitly, treating Internet variables as a function of a linear time trend of the Postal Service's own estimates of diversion over the past six years, but soon abandoned that approach.

Instead of attempting to include an Internet factor directly, the Postal Service's current demand model, including the one used in Docket No. R2013-11, attempts to capture electronic diversion indirectly through trend and intervention factors. One shortcoming of this approach is that trends and intervention factors have no economic meaning. As the Commission recently stated, "Intervention variables and trends indicate that something happened, they

at 9 (February 16, 2012) (stating "Diversion of communication and commerce to electronic channels is a principal contributor to declining First-Class Mail volumes"); USPS Form 10-K report for FY 2013 at 12 ("Our business and results of operations are adversely affected by electronic diversion.")

do not attempt to explain why that something happened.” Order No. 1926 at 75, Docket No. R2013-11. Therefore, to the (unknown) extent that trends and intervention factors are reflecting what in fact are price effects, then the price elasticities generated by the model will be inaccurate.

In other words, the Postal Service’s econometric model may be specified in such a way as to subsume price effects in other factors. Indeed, the Commission cited this very possibility as a flaw in Docket No. R2013-11, noting that the variables used in the volume model “make it difficult to estimate the effects of the Great Recession because they do not cleanly separate the effects of economic activity from electronic or other diversion.” Order No. 1926, Docket No. R2013-11 at 63 (Dec. 24, 2013).¹⁶

Although the Commission ultimately based part of its decision in the R2013-11 exigency case on the Postal Service’s volume model, it found numerous problems with the model’s specifications. Its criticism of the model’s treatment of electronic diversion was strong:

It is “particularly important that electronic diversion of mail volumes be adequately represented in demand equations that are to be used to estimate the effect of the Great Recession because it is electronic diversion that is most likely to be mistakenly attributed to the Great Recession by an incorrect model. Unfortunately, the model on record in this proceeding represents electronic diversion in an inferior manner.”

¹⁶ See also Order No. 1926 at 67 (“this record is void of an econometric model that clearly separates the impact of internet or electronic diversion on mail volume”). The Commission rejected as simply “not plausible” (Order No. 1926 at 80) the Postal Service’s contention in Docket No. R2013-11 that electronic diversion had remained constant for a number of years and had little, if any, causal effect on the volume decreases during the recent recession. Response to POIR No. 6, Q25(a) (Thress) (stating that the Postal Service assumed that the rate of electronic diversion would “remain constant in the absence of evidence to the contrary”).

Order No. 1926 at 64. Other parties voiced other criticisms of the Postal Service's volume forecasting model in Docket No. R2013-11. Professor Christian Lundblad, on behalf of MPA *et al.*, criticized the Postal Service model's treatment of Internet diversion on a number of grounds, as did Dr. James Clifton on behalf of the Greeting Card Association.

The Commission's concern with current elasticity estimates has continued beyond the exigency case. Its recent Annual Compliance Determination for Fiscal Year 2013 also urged the Postal Service to improve its elasticity estimates for Standard Mail products to address the apparent unprofitability of certain products. *Annual Compliance Determination Report Fiscal Year 2013* at 55 (March 27, 2014).

Third, the real inflation-adjusted price of major categories of mail has changed very little since the PAEA took effect (and even during the years before). See *Buc Declaration* at 8-10. This is to be expected from a regulatory system that generally caps price increases at inflation. However, a consequence of this stability in real prices is that there has been very little price effect on volumes over that period, precisely because real prices have remained essentially unchanged. As a result, the model can provide little information of the effects on volume of price changes that depart significantly from inflation levels, a point on which the Postal Service has agreed.¹⁷

Fourth, the Postal Service's econometric model uses data that are 20 to 30 years old. The sweeping changes in communications and technology in

¹⁷ See Reply Statement of Thomas E. Thress, Docket No. R2013-11 at 37 (Dec. 6, 2014).

recent years have so transformed the postal market that one reasonably may question whether such older data are relevant today.

In light of these ongoing concerns and criticisms, a thorough and thoughtful review of postal price elasticities and related issues with the prevailing volume model would be desirable and advance the public interest. Petitioners submit that now would be an appropriate time for the Commission to conduct such a review. Commencing a review at this time not only would provide more time for thoughtful consideration and analysis outside of the time constraints of a litigated case, but could provide useful information in advance of the statutory requirement that the Commission conduct a 10-year review of the ratesetting system for market-dominant products in 2017.

II. JURISDICTION

Section 503 of the Postal Accountability and Enhancement Act of 2006 broadly authorizes the Commission to promulgate regulations or take “any other action” it deems necessary to carry out its functions. 39 U.S.C. §503. That statutory provision, and regulations implemented thereunder, provide the authority for the relief requested herein.

The Postal Service currently files its volume methodology in January of each year pursuant to Section 3050.26 of the Commission’s rules of practice, entitled “Documentation of demand elasticities and volume forecasts.” That section provides:

By January 20 of each year, the Postal Service shall provide econometric estimates of demand elasticity for all postal products accompanied by the underlying econometric models and the input data sets used;

and a volume forecast for the current fiscal year, and the underlying volume forecasting model.

39 C.F.R. §3050.26. Section 3050.60(f) of the Commission's rules requires that the Postal Service subsequently file, by July 1 of each year:

(f) Succinct narrative explanations of how the estimates in the most recent Annual Compliance Determination were calculated and the reasons that particular analytical principles were followed. The narrative explanations shall be comparable in detail to that which had been provided in Library Reference 1 in omnibus rate cases processed under the Postal Reorganization Act (by July 1 of each year).

39 C.F.R. §3050.60.

These Postal Service's volume forecasting models use "analytical principles" as defined by the Commission's rules. 39 C.F.R. §3050.1(c) & §3050.10. Section 3050.11 of the Commission's rules of practice authorize any interested person, or the Commission *sua sponte*, to propose revising an "analytical principle." 39 C.F.R. §3050.11. This petition is filed pursuant to that provision.

Currently, the Commission does not specify the particular analytical principles used in those models, but its rules implicitly reserve for it the power to do so. See 39 C.F.R. §3050.10 (noting that the Postal Service may use an analytical principle in its volume model "prior to its acceptance by the Commission"). When a particular "analytical principle" used in a volume demand model filed in any given year is "accepted" by the Commission is not entirely clear, but it is reasonable to conclude that the Commission does so when it relies on a model in an exigency case under 39 U.S.C. §3622(d)(1)(E). This occurred recently in December 2013, in Docket No. R2013-11.

In addition, the Commission uses these filed volume models in evaluating market-dominant NSAs as part of its Annual Compliance Determination under Section 3653. In particular, price elasticities are an integral component of the Commission's preferred methodology for calculating the financial effects of an NSA. Thus, they are be "accepted" at least to the extent necessary when used to evaluate NSAs. It is evident that accurate price elasticity estimates are especially desirable, even necessary, in this application.

Furthermore, Section 3651 provides that the Commission shall submit an annual report concerning its operations and, *inter alia*, the universal service obligation. Subsection (c) directs the Postal Service to provide the Commission "with such information as may, in the judgment of the Commission, be necessary to enable the Commission to prepare its report." 39 U.S.C. §3651(c). That provision gives the Commission authority to seek from the Postal Service accurate information regarding price elasticities, Internet diversion, and volume models, all matters potentially relevant to these reports, an authority that goes beyond the mere filing of periodic reports.

Finally, commencing this proceeding now would be timely. Obtaining a more thorough and accurate understanding of the factors that affect postal volumes, including prices and diversion, potentially should serve a useful role in the Commission's upcoming 10-year review of the current system of postal ratemaking for market dominant products. See 39 U.S.C. §3622(d)(3). There is no reason to delay the process of obtaining improved information in anticipation of that review.

III. THE COMMISSION SHOULD TAKE A BALANCED MULTI-STEP APPROACH TO IMPROVING ELASTICITY, DIVERSION, AND DEMAND ESTIMATES

Petitioners urge the Commission to initiate and conduct a proceeding to review and improve the price elasticity estimates and related volume forecasting models used by the Commission and Postal Service. This effort should include both a modeling of mailer behavior, based on interviews and surveys, and a re-estimating of the econometric demand equations.

As a first step, the Commission should try to reconcile the elasticity estimates derived from mailer surveys and analyses with the estimates generated by the Postal Service's volume forecasting methodology. To do this, the Commission could (1) engage an appropriate survey of mailers to identify the effect of postal prices and the Internet on their mailing decisions, and (2) convene a proceeding to identify ways to improve the econometric modeling of electronic diversion, which affects price elasticity estimates.

A. Estimate The Responsiveness Of Mail Volume To Postal Prices By Modeling Firm Behavior

This aspect of improving the estimates of price elasticity would involve building firm-level models for both transactional and marketing mail. There are five subtasks.

- Obtain a sample of firms that are (1) willing to participate in discussions and provide data and (2) comprise a valid, projectable sample. Petitioners and mailing or related trade associations can more generally help with the first part of this task.
- Interview decision makers in these firms to understand how they make mailing decisions.

- Based on the insights from the interviews, build conceptual economic models that reflect firms' behavior. For example, in marketing, firms maximize their ROI or the NPV of their business by mailing only so long as additional mail volume is profitable. Using firms' estimates of response rates, costs of goods they are selling, and the prices they can charge, then one can build a model of firm mailing behavior that calculates marketing mail volume as a function of mail price with all other variables at their current values. Alternatively, researchers could just use the outputs of the firms marketing models, rather than create them *de novo*.
- After constructing the models, use input data from firms to populate the models to produce mail volumes as a function of mail prices. Running the models at increased and decreased mail prices calculates how mail volume changes as mail prices change.
- The final step is to aggregate across model firms to produce national estimates of how mail volume changes are induced by postal price changes.

B. Estimate the Responsiveness of Consumer Mail Volume by Modeling Household Mailing Behavior

When reviewing the elasticity of First-Class Single-Piece Mail, it would be important to recognize that individuals (households) predominantly use that product. It would be important to distinguish the different uses to which consumers put this product. The Postal Service *Household Diary Study* already provides a convenient and seemingly reasonable breakdown into "personal" and "transaction" household mail, and subdivides these categories further by application (greeting cards, personal letters, bill payments, charitable donations, etc.).

The five subtasks identified in A., above, except for the third, could provide a groundwork for this research. In place of the ROI- or NPV-driven tests identified in the third subtasks, researchers would need to have consumers explain the standards by which they decide among mail communication,

electronic communication, or, perhaps, no communication in particular instances. Modeling overall consumer mailing behavior, however, might proceed along the same lines as for business mailers.

C. Improve The Econometric Modeling

Concurrently, the Commission should conduct an effort to correct the flaws that it has identified in the current demand equations. Well-specified demand equations would (1) separate the effects of economic activity from those of electronic diversion, (2) be complete with respect to its choice of macroeconomic variables, (3) include only relevant time periods when estimating the elasticities; and (4) not conflate the effects of the recent recession with other factors. Such equations would estimate volumes with a much reduced reliance on trend and intervention variables, instead replacing them with relevant variables having economic content. And the resulting equations should pass standard statistical tests and have standard statistical properties, as is standard Commission practice.

Once the demand equations have been re-estimated, price elasticities of demand can be recovered using standard techniques.

The Commission has flexibility to set other procedures. This process should be open to public comment. Informal workshops may be useful as well. Given the known shortcomings of the current econometric model, Petitioners are optimistic that such an effort may reduce the disparities between the results derived from mailer surveys and those derived econometrically.

It may also be useful to review the experience of foreign posts operating in nations in which broadband Internet services are equally or more available (and often at lower price) than in the United States. Such a review may assist in identifying the econometric factors most relevant to electronic diversion, and to assess implications for price elasticities of demand in the future.

D. Compare The Outcomes Of The Two Approaches

These first two steps should provide the Commission with substantially more information than currently exists regarding demand equations, elasticities, and electronic diversion. Elasticities derived from the firm-level models and the modeling of consumer behavior can then be compared to those derived from the econometric demand estimates. To the extent that they are reasonably close to each other for the relevant product groupings, the project has been successful. To the extent that they are not, it will be useful to reexamine the work in the task which estimate the elasticities.

It may be appropriate to defer until that comparison stage a decision regarding what next steps should be taken. In particular, Petitioners do not recommend at this time that the Commission by regulation specify a particular volume and elasticity model, although that is a possible outcome of this proceeding. At present, there likely will be a need for adequate flexibility to adjust and improve the model. In addition, there likely will be a need to reconsider annually whether (and how) to adjust the econometric volume model. The Commission today has experience considering requests by the Postal Service and others to modify approved costing methodologies. The Commission

may draw upon that experience in determining whether eventually to establish a particular model by regulation.

IV. CONCLUSION

For these reasons, the undersigned Petitioners respectfully request that the Commission initiate a proceeding to review the econometric demand estimates and their associated price elasticities of demand for major market-dominant postal products and the estimates of Internet diversion.

Respectfully submitted,

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